JOHN HANCOCK TAX-ADVANTAGED DIVIDEND INCOME FUND
Form DEFA14A
December 16, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

SCHEDULE 14A

PROXY STATEMENT PURSUANT TO SECTION 14(a) OF THE SECURITIES

EXCHANGE ACT OF 1934 (Amendment No. ______)

Filed by the Registrant x

Filed by a Party other than the Registrant ¨

Check the appropriate box:

¨	Preliminary Proxy Statement
¨	Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))
¨	Definitive Proxy Statement
x	Definitive Additional Materials
¨	Soliciting Material Under §240.14a-12

JOHN HANCOCK TAX-ADVANTAGED DIVIDEND INCOME FUND

(Name of Registrant as Specified in Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

x	No fee required.

¨ Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

1) Title of each class of securities to which transaction applies:

2) Aggregate number of securities to which transaction applies:

3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

4) Proposed maximum aggregate value of transaction:

5) Total fee paid:

¨ Fee paid previously with preliminary materials:

¨ Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

1) Amount Previously Paid:

2) Form, Schedule or Registration Statement No.:

3) Filing Party:

4) Date Filed:

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Your browser must support JavaScript 1.1 or higher in order to continue. Click on the Help link at the bottom for more information and navigation tips. If you are unable to vote your proxy using this service because of technical difficulties, you should refer to your Proxy Package for other voting options.

The proxy materials are available via VIEW MATERIALS on this page and on the bottom of each page of this site. You can request paper copies or electronic delivery by clicking on the **REQUEST MATERIALS** option. Permanent elections for future proxies can be made by clicking on **SET FUTURE PREFERENCES**. Requesting paper materials for current or future proxies will be at no additional cost to you. If you are ready to vote, please click **CONTINUE TO VOTING**.

VIEW MATERIALS ONLINE

To view your documents please click the appropriate link below.

You may need Adobe Acrobat to view the documents listed above. To download Adobe Reader, click the address below http://www.adobe.com/products/acrobat/readstep.html

Home · Contact Us · Security · Privacy Policy · Help · **View Materials**

REQUEST MATERIALS

You can choose to receive **Proxy Materials** for this campaign only, via electronic delivery or regular mail by selecting an option below. When selecting electronic delivery you will receive an e-mail containing a link to the proxy materials. When ordering materials by regular mail before the meeting date, we suggest you place your order at least 10 calendar days prior to the meeting to ensure receipt and time to register your vote.

If you would like to make an election to receive electronic delivery or paper copies for all future campaigns, please go back to the All Options Page and click on **Set Future Preferences** after you have completed this screen.

Your 14 digit and 8 digit codes from your notice have been assigned to you for voting on this site prior to the meeting.

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If you would like to receive electronic delivery or paper materials, you must **also** make that election by clicking on the **Request Materials** link on the All Options Page.

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PROXY IS SOLICITED BY THE BOARD OF TRUSTEES

OF JOHN HANCOCK FUNDS FOR ANNUAL MEETING OF SHAREHOLDERS ON FEBRUARY 3, 2016

The undersigned, revoking previous proxies, hereby appoint(s) Andrew G. Arnott, Ariel Ayanna, John J. Danello, Thomas Dee, Kinga Kapuscinski, Nicholas Kolokithas, Charles A. Rizzo, Betsy Anne Seel, Christopher Sechler, and Andrew Wilkins, or any one or more of them, proxies and attorneys of the undersigned, each with full power of substitution, to vote all common shares of the said Fund, which the undersigned is entitled to vote at the Annual Meeting of Shareholders of the Fund to be held on February 3, 2016, at the offices of the Fund, 601 Congress Street, Boston, Massachusetts 02210, at 2:00 p.m., Eastern Time, and at any adjournments thereof. All powers may be exercised by a majority of said proxy holders or substitutes voting or acting or, if only one votes and acts, then by that one. Receipt of the Notice of the Annual Meeting of Shareholders and the accompanying Proxy Statement is hereby acknowledged.

Proposals

1.01	To Elect: James R. Boyle	¡ For ¡ Withhold
1.02	To Elect: Craig Bromley	¡ For ¡ Withhold
1.03	To Elect: Deborah C. Jackson	¡ For ¡ Withhold
1.04	To Elect: James M. Oates	¡ For ¡ Withhold
1.05	To Elect: Steven R. Pruchansky	¡ For ¡ Withhold

Thank you. Your voting instructions have been submitted for processing.

If necessary, you can revisit the Internet voting site at any time before the meeting on 2/03/2016 2:00 PM ET to submit new voting instructions.

This is a summary of your voting instructions for the John Hancock 2015 Annual Meeting. You may print this page for your records.

Instructions submitted on
12/14/2015 4:41:02 PM [ET]

1.01	To Elect: James R. Boyle	Voted For
1.02	To Elect: Craig Bromley	Voted For
1.03	To Elect: Deborah C. Jackson	Voted For
1.04	To Elect: James M. Oates	Voted For
1.05	To Elect: Steven R. Pruchansky	Voted For

Enter your e-mail address in the following textbox if you would like an e-mail confirmation of your vote.

Thank you. Your voting instructions have been submitted for processing.

If necessary, you can revisit the Internet voting site at any time before the meeting on 2/03/2016 2:00 PM ET to submit new voting instructions.

This is a summary of your voting instructions for the John Hancock 2015 Annual Meeting. You may print this page for your records.

Instructions submitted on
12/14/2015 4:41:17 PM [ET]

1.01	To Elect: James R. Boyle	Voted Withhold
1.02	To Elect: Craig Bromley	Voted Withhold
1.03	To Elect: Deborah C. Jackson	Voted Withhold
1.04	To Elect: James M. Oates	Voted Withhold
1.05	To Elect: Steven R. Pruchansky	Voted Withhold

Enter your e-mail address in the following textbox if you would like an e-mail confirmation of your vote.

NOTICE AND ACCESS: MATERIALS REQUEST TOUCH-TONE TELEPHONE SCRIPT

"WO# 27108 - JOHN HANCOCK FUNDS PROXY"

EXPECTED MAIL DATE: 12/16/15 - MEETING DATE: 02/03/2016

WHEN CONNECTED TO OUR TOUCH TONE PHONE ORDERING SYSTEM ACCESSED VIA OUR TOLL-FREE NUMBER(1-877-816-5331) , THE SHAREHOLDER WILL HEAR:

INITIAL GREETING:

"Thank you for calling the Proxy Materials Order Line."

"This line is available to you until the meeting date of the current campaign"

THEN THE SHAREHOLDER IS PROMPTED TO ENTER THEIR CONTROL NUMBER:

"To request a copy of proxy materials by mail, I'll need to validate some information from your Meeting Notice."

"On your notice there's a shaded box with a 14 digit number inside. Please enter that number now."

AFTER ENTRY OF THEIR CONTROL NUMBER, THEY ARE PROMPTED TO ENTER THEIR SECURITY CODE:"

"Next, located in the un-shaded box is an 8 digit number. Please enter this number now.

THEN YOU HEAR:

"Thank you, Please hold while I validate those numbers."

IF THE CODES ENTERED WERE VALID, THE CAMPAIGN SPECIFIC SPEECH IS HEARD NEXT:

"Okay, you'll be requesting meeting materials for John Hancock Funds."

THEN THE FOLLOWING SPEECH IS HEARD:

"Your request for a paper copy of your proxy materials will be processed in just a moment. For future meetings you can elect to receive proxy materials by email or by mail. If you prefer email, please log on to the web site listed on your shareholder meeting Notice so that we can capture your email address. If you prefer to receive all future proxy materials by mail, press 1 now. If you don't want to set a future delivery preference, just hold on for your material order confirmation."

NEXT, THE SHAREHOLDER HEARS:

"Please hold while I process your request."

THEN THE SHAREHOLDER HEARS:

"Your request has been received. Proxy material orders will be mailed within 3 business days."

OR, IF THE SHAREHOLDER HAS A PENDING ORDER THEY HEAR THIS SPEECH INSTEAD:

"There's already a request for proxy meeting materials that's pending. Material orders are mailed within 3 business days from when they were requested."

IF THE MEETING IS WITHIN 10 DAYS OF THE CALL, THE SHAREHOLDER WILL HEAR:

"Since the meeting is within 10 days, I cannot guarantee that you'll receive your proxy materials in sufficient time for you to review the materials and process your vote. However, you can always view your proxy materials and vote online by logging onto the website listed on your shareholder meeting notice."

IF THE SHAREHOLDER ELECTED TO RECEIVE ALL FUTURE PROXY MATERIALS BY MAIL THEY WILL HEAR:

"Additionally, as you've indicated, you'll receive all future proxy meeting materials by mail."

THEN THE SHAREHOLDER IS PROMPTED TO SEE IF THEY HAVE ANOTHER NOTICE:

"If you have received a notice on another account that you'd like me to send you materials on, press one now."

THEN IF THE SHAREHOLDER ELECTS TO ORDER MATERIALS FOR ANOTHER NOTICE:

"Okay, to send you materials on another account we'll just need to repeat the process using the details from your other notice. Let's begin..."

IF THE SHAREHOLDER DOESN'T CHOOSE THE OPTION TO ORDER MATERIALS FOR ANOTHER NOTICE, THEY HEAR:

"I'm now going to end this call. Thank you for calling. Goodbye."

JOHN HANCOCK PROXY WO # 27108 - TOUCH-TONE TELEPHONE VOTING SCRIPT

**** PROXY CARD ****

WHEN CONNECTED TO OUR PHONE VOTING SYSTEM ACCESSED VIA OUR TOLL-FREE NUMBER 1-800-337-3503, THE SHAREHOLDER HEARS:

THE INITIAL PROMPT:

"Thank you for calling the proxy voting line.

Before you can vote, I'll need to validate some information from your proxy card or meeting notice.

On your card or notice there's a shaded box with a 14 digit number inside. Please enter that number now."

AFTER THE SHAREHOLDER ENTERS THEIR 14 DIGIT CONTROL NUMBER, HE/SHE HEARS:

"Next, located in the un-shaded box is an 8 digit number. Please enter this number now."

THEN YOU HEAR:

"Thank you. Please hold while I validate those numbers."

IF CUSTOM GREETING IS APPROVED, THE SHAREHOLDER WILL HEAR THE FOLLOWING CUSTOM SPEECH:

Okay, you'll be voting your proxy for shares in the John Hancock Funds. The Board Recommends a vote "FOR" the proposal."

IF THERE IS A PRIOR VOTE IN THE SYSTEM FOR THE CONTROL NUMBER ENTERED YOU HEAR:

" I see that you've already voted. If you don't want to change your vote you can just hang-up. Otherwise, remain on the line and I'll take you through the voting process again..."

IF THERE IS NO PRIOR VOTE, THE FOLLOWING IS HEARD:

"I'm about to take you through the voting process. Please keep your voting card or meeting notice in front of you to follow along. Okay, let's begin…"

THEN, MATCHING THE SHAREHOLDER'S PROXY CARD, THEY WILL BE PROMPTED TO VOTE ON THE PROPOSAL:

"PROPOSAL 1: To vote FOR ALL nominees, Press 1**. To WITHHOLD your vote from all nominees, press 2.**

Or to **WITHHOLD YOUR VOTE FROM INDIVIDUAL nominees** press 3."

IF THE SHAREHOLDER PRESSES 1, TO VOTE FOR ALL NOMINEES THEY WILL HEAR:

"Okay, voting for all nominees"

IF THE SHAREHOLDER PRESSES 2, TO WITHHOLD FROM ALL NOMINEES THEY WILL HEAR:

"Okay, voting withhold on all nominees "

IF THE SHAREHOLDER PRESSES 3, TO WITHHOLD FROM INDIVIDUAL NOMINEES THEY WILL HEAR:

"Okay, we'll withhold your vote on the nominees you specify. All other nominees will be voted FOR. "

THEN THEY HEAR: "For each nominee listed on your proxy card or meeting notice there's a corresponding two-digit number. Please enter the number of the nominee from whom you wish to withhold your vote."

AFTER THE SHAREHOLDER ENTERS A NOMINEE NUMBER TO WITHHOLD FROM, HE/SHE HEARS:

"OK, withholding your vote from nominee number N" [Where N is the nominee number entered]"

THEN THE SHAREHOLDER HEARS:

"To withhold your vote from another nominee, enter the two-digit number. If there are no other nominees from whom you wish to withhold your vote press # (pound)."

WHEN # IS PRESSED, THE SHAREHOLDER HEARS:

"Okay, finished withholding from nominees"

WHEN THE SHAREHOLDER HAS COMPLETED VOTING ON THE PROPOSALS, HE/SHE WILL HEAR:

"Okay, you've finished voting but your vote has not yet been recorded."

"To hear a summary of how you voted, press 1; To record your vote, Press 2."

IF THE SHAREHOLDER PRESSES 1, TO HEAR A SUMMARY OF THEIR VOTES, HE/SHE WILL HEAR:

"Please note your vote will be cast automatically should you decide to hang up during the summary."

"You've elected to vote as follows..." **[THEN A PLAYBACK OF THE VOTES COLLECTED FOR EACH PROPOSAL IS HEARD]**

AFTER THE VOTE PLAYBACK, THE SHAREHOLDER HEARS:

"If this is correct, press 1; Otherwise, press 2. If you'd like to hear the information again press # (pound)."

IF THE CALLER CHOOSES TO RECORD THEIR VOTE (EITHER BEFORE OR AFTER THE SUMMARY IS HEARD), THEY HEAR:

"(Okay) Please hold while I record your vote."

THEN THEY HEAR:

"Your vote has been recorded. It's not necessary for you to mail in your proxy card or meeting notice. I'm now going to end this call unless you have another proxy card or meeting notice to vote or you want to change your vote. If you need to vote again, press one now."

IF THE SHAREHOLDER PRESSES 2, INDICATING AN INCORRECT VOTE, HE/SHE WILL HEAR:

"Okay, lets change your vote." **[The system then prompts the voting options again.]**

AFTER THE SHAREHOLDER'S VOTE IS RECORDED, IF THEY ELECT TO VOTE ANOTHER PROXY, HE/SHE HEARS:

"Before you can vote, I'll need to validate some information from your proxy card or meeting notice. On your card or notice there's a shaded box with a 14 digit number inside. Please enter that number now."

IF THE SHAREHOLDER ELECTS TO END THE CALL, HE/SHE WILL HEAR:

"Thank you for voting, goodbye."

Back to Mutual Funds Overview

Proxy Voting

Proxy Voting for John Hancock Shareholders:

The following funds are currently conducting a proxy vote:

John Hancock Fundamental Large Cap Core

The proxy vendor will be BFDS; click here for their website.

Closed-end funds

Shareholders of record as of the close of business on November 24, 2015 are cordially invited to attend the annual meeting of shareholders on Wednesday, February 3, 2016, at 2:00 P.M., Eastern Time, to be held at 601 Congress Street, Boston, Massachusetts 02210. Click here for directions.

John Hancock Financial Opportunities Fund

John Hancock Hedged Equity & Income Fund

John Hancock Income Securities Trust

Related Resources

Download letter to shareholders, notice of meeting and proxy statement

John Hancock Financial Opportunities Fund

John Hancock Hedged Equity & Income Fund

John Hancock Income Securities Trust

John Hancock Investors Trust

John Hancock Preferred Income Fund

John Hancock Preferred Income Fund II

John Hancock Preferred Income Fund III

John Hancock Investors Trust

John Hancock Preferred Income Fund

John Hancock Preferred Income Fund II

John Hancock Preferred Income Fund III

John Hancock Premium Dividend Fund

John Hancock Tax-Advantaged Dividend Income Fund

John Hancock Tax-Advantaged Global Shareholder Yield Fund

Portfolio Manager Proxy Voting Records

Choose a fund to view the proxy voting activity for each company held in the fund's portfolio.

Proxy Voting Policies and Procedures

John Hancock Investments Proxy Voting Policies and Procedures

John Hancock Premium Dividend Fund

John Hancock Tax-Advantaged Dividend Income Fund

John Hancock Tax-Advantaged Global Shareholder Yield Fund

Vote your proxy

Closed-End Funds

Please refer to your proxy card(s) for internet voting website address. Please call 855-742-8269 if you have any questions.

Get fund information

John Hancock Financial Opportunities Fund

John Hancock Hedged Equity & Income Fund

John Hancock Income Securities Trust

John Hancock Investors Trust

John Hancock Preferred Income Fund

John Hancock Preferred Income Fund II

John Hancock Preferred Income Fund III

John Hancock Premium Dividend Fund

John Hancock Tax-Advantaged Dividend Income Fund

John Hancock Tax-Advantaged Global Shareholder Yield Fund

Click here to view prospectuses for open-end, retirement, and institutional funds. A fund's investment objectives, risks, charges, and expenses should be considered carefully before investing. The prospectus contains this and other important information about the fund. Please read the prospectus carefully before investing or sending money. These products are available for sale only within the United States.

NOT FDIC INSURED. MAY LOSE VALUE. NO BANK GUARANTEE. NOT INSURED BY ANY GOVERNMENT AGENCY.

Version 18.3.5.1

;

Advances from Federal Home Loan Bank

25,000

25,000

53,000

Federal funds purchased and repurchase agreements	**1,156**	2,295	2,256
Other borrowings	**1,600**	4,300	-
Junior subordinated debentures	**14,433**	14,433	14,433
Other liabilities	**7,128**	6,260	4,654
Total liabilities	**790,120**	759,135	684,979
Preferred stock (10,000,000 shares authorized, none issued and outstanding)	-	-	-

Common stock ($1 par value, 20,000,000 shares authorized, 10,097,272, 10,053,572 and 9,810,099 shares issued at June 30, 2005, December 31, 2004 and June 30, 2004, respectively

10,097

10,054

9,810

Additional paid-in capital

28,296

27,954

24,795

Retained earnings

47,751

44,642

42,296

Accumulated other comprehensive (loss) income

(251
)

56

35

Less: Treasury stock at cost; 1,551,186 shares at June 30, 2005 and December 31, 2004 and 1,477,386 shares at June 30, 2004

(13,504
)

(13,504
)

(12,544
)
Total stockholders' equity

72,389

69,202

			64,392
Total liabilities and stockholders' equity	**$ 862,509**	$ 828,337	$ 749,371

See accompanying notes to unaudited consolidated financial statements.

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FLAG FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF EARNINGS
(in thousands, except per share data)

	Three Months Ended June 30, 2005	Three Months Ended June 30, 2004	Six Months Ended June 30, 2005	Six Months Ended June 30, 2004
		(unaudited)		
Interest income:				
Interest and fees on loans	**$ 12,430**	$ 8,680	**$ 23,841**	$ 16,798
Interest on investment securities	**1,305**	1,292	**2,380**	2,748
Interest on federal funds sold and other interest-bearing deposits	**329**	99	**630**	199
Total interest income	**14,064**	10,071	**26,851**	19,745
Interest expense:				
Interest on deposits:				
Demand	**1,962**	1,183	**3,624**	2,233
Savings	**32**	32	**63**	67
Time	**2,381**	1,183	**4,512**	2,421
Interest on other borrowings	**442**	314	**826**	533
Total interest expense	**4,817**	2,712	**9,025**	5,254
Net interest income before provision for loan losses	**9,247**	7,359	**17,826**	14,491
Provision for loan losses	**-**	375	**375**	1,095
Net interest income after provision for loan losses	**9,247**	6,984	**17,451**	13,396
Noninterest income:				
Service charges on deposit accounts	**824**	958	**1,573**	1,850
Mortgage banking activities	**687**	595	**1,267**	1,125
Insurance commissions and brokerage fees	**58**	163	**132**	276
Gain on sale of branch	**-**	-	**-**	3,000
Gain on sales of other real estate owned	**131**	38	**222**	35
Gain on sales of investment securities available-for-sale	**6**	685	**129**	693
Other	**886**	152	**1,871**	304
Total noninterest income	**2,592**	2,591	**5,194**	7,283
Noninterest expense:				
Salaries and employee benefits	**5,227**	4,077	**10,220**	8,867
Occupancy	**982**	863	**1,938**	1,773
Professional fees	**484**	282	**1,033**	582
Postage, printing and supplies	**231**	214	**477**	449
Communications	**596**	530	**1,109**	1,114
Other	**902**	768	**1,762**	1,936
Total noninterest expense	**8,422**	6,734	**16,539**	14,721
Earnings before provision for income taxes	**3,417**	2,841	**6,106**	5,958

Provision for income taxes		**1,111**		920		**1,973**		1,941
Net earnings	**$**	**2,306**	$	1,921	**$**	**4,133**	$	4,017
Basic earnings per share	**$**	**0.27**	$	0.23	**$**	**0.48**	$	0.47
Diluted earnings per share	**$**	**0.25**	$	0.21	**$**	**0.45**	$	0.44

See accompanying notes to unaudited consolidated financial statements.

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FLAG FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	**2005**	2004
		(unaudited)		
Net earnings	**$ 2,306**	$ 1,921	**$ 4,133**	$ 4,017
Other comprehensive income (loss), net of tax:				
Unrealized gains (losses) on investment securities available-for-sale:				
Unrealized gains (losses) arising during the period, net of tax of $67, $583, $159 and $458, respectively	**110**	(950)	**(259)**	(746)
Reclassification adjustment for gains included in net earnings, net of tax of $2, $3, $49 and $263, respectively	**(4)**	(5)	**(80)**	(430)
Unrealized gain on cash flow hedges, net of tax of $20, $0, $20 and $0, respectively	**32**	-	**32**	-
Other comprehensive income (loss)	**138**	(955)	**(307)**	(1,176)
Comprehensive income	**$ 2,444**	$ 966	**$ 3,826**	$ 2,841

See accompanying notes to unaudited consolidated financial statements.

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FLAG FINANCIAL CORPORATION AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Six Months Ended June 30, 2005	2004
	(unaudited)	
Cash flows from operating activities:		
Net earnings	**$ 4,133**	$ 4,017
Adjustment to reconcile net earnings to net cash provided by (used in) operating activities:		
Depreciation, amortization and accretion	**1,063**	1,642
Provision for loan losses	**375**	1,095
Gain on sale of branch office	**-**	(3,000)
Gain on sales of investment securities available-for-sale	**(129)**	(693)
Gain on sales of loans	**(362)**	(651)
(Gain) loss on disposals of premises and equipment	**(25)**	33
Gain on sales of other real estate owned	**(222)**	(35)
Change in:		
Mortgage loans held-for-sale	**1,944**	(1,079)
Other assets and liabilities	**(684)**	(3,110)
Net cash provided by (used in) operating activities	**6,093**	(1,781)
Cash flows from investing activities:		
Cash paid in branch sale	**-**	(14,141)
Net change in other interest-bearing deposits	**582**	99
Proceeds from sales, calls and maturities of investment securities available-for-sale	**70,075**	47,027
Purchases of investment securities available-for-sale	**(70,118)**	(24,332)
Proceeds from sales and maturities of other investments	**1,071**	1,760
Purchases of other investments	**(242)**	-
Net change in loans	**(45,112)**	(63,538)
Proceeds from sales of other real estate owned	**2,030**	442
Proceeds from sales of premises and equipment	**881**	-
Purchases of premises and equipment	**(766)**	(315)
Purchases of cash surrender value life insurance	**(118)**	(74)
Net cash used in investing activities	**(41,717)**	(53,072)
Cash flows from financing activities:		
Net change in deposits	**33,956**	75,822
Change in federal funds purchased and repurchase agreements	**(1,139)**	(1,842)
Change in other borrowings	**(2,700)**	(1,100)
Payments of FHLB advances	**-**	(5,000)
Proceeds from issuance of junior subordinated debt	**-**	14,433
Purchase of treasury stock	**-**	(2,967)
Proceeds from exercise of stock options	**385**	273
Cash dividends paid	**(1,029)**	(1,015)
Net cash provided by financing activities	**29,473**	78,604

Net change in cash and cash equivalents		**(6,151)**		23,751
Cash and cash equivalents at beginning of period		**40,316**		36,737
Cash and cash equivalents at end of period	**$**	**34,165**	$	60,488

See accompanying notes to unaudited consolidated financial statements.

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Flag Financial Corporation and Subsidiary
Notes to Consolidated Financial Statements

The accompanying consolidated financial statements have not been audited. The results of operations are not necessarily indicative of the results of operations for the full year or any other interim periods.

Note 1. Basis of Presentation

The consolidated financial statements include the accounts of Flag Financial Corporation ("Flag" or the "Company") and its wholly owned subsidiary, Flag Bank (the "Bank"). All significant intercompany accounts and transactions have been eliminated in consolidation.

The consolidated financial information furnished herein represents all adjustments that are, in the opinion of management, necessary to present a fair statement of the results of operations, and financial position for the periods covered herein and are normal and recurring in nature. For further information, refer to the consolidated financial statements and related notes included in Flag's annual report on Form 10-K for the year ended December 31, 2004.

Note 2. Mergers and Acquisitions

On May 26, 2005, Flag and First Capital Bancshares, Inc. ("First Capital") entered into a definitive agreement for Flag to acquire First Capital. First Capital, a bank holding company, is headquartered in Norcross, Georgia and is the parent company of First Capital Bank, which operates five banking offices in the north metro Atlanta market. The acquisition of First Capital will significantly accelerate Flag's growth strategy, more than doubling its presence in the metro Atlanta market. As of June 30, 2005, First Capital has approximately $675 million in assets. The consideration will be a combination of cash and stock with the transaction valued at approximately $122.7 million. The agreement has been approved by both boards of directors and is subject to regulatory and shareholders approvals. The merger is expected to close in the fourth quarter of 2005.

Note 3. Recent Accounting Pronouncements

As permitted by SFAS No. 123, *Accounting for Stock-Based Compensation*, Flag currently accounts for share-based payments to employees using APB opinion No. 25's intrinsic value method and, as such, generally recognizes no compensation expense for employee stock options. The impact of adoption of SFAS No. 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, had we adopted SFAS No.123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net income earnings per share in Note 5 to our consolidated financial statements. SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in the periods after adoption. While the Company cannot estimate what those amounts will be in the future (because they depend on, among other things, when employees exercise stock options), the amount of operating cash flows recognized in prior periods for such excess tax deductions were insignificant. SFAS No. 123(R) is effective as of the beginning of the first interim or annual reporting period that begins after June 15, 2005. On April 14, 2005, the Securities and Exchange Commission (the "SEC") announced a new rule that amends the compliance dates for SFAS No. 123(R). The SEC's new rule allows companies to implement SFAS No. 123(R) at the beginning of their next fiscal year, instead of the next reporting period that begins after June 15, 2005. Flag will adopt the standard in the first quarter of 2006.

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Note 4. Net Earnings Per Common Share

Net earnings per common share are based on the weighted average number of common shares outstanding during each period. The calculation of basic and diluted earnings per share is as follows (in thousands, except per share amounts):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	**2005**	2004
Basic earnings per share:				
Net earnings	**$ 2,306**	$ 1,921	**$ 4,133**	$ 4,017
Weighted average common shares outstanding	**8,537**	8,457	**8,526**	8,493
Basic earnings per share	**$ 0.27**	$ 0.23	**$ 0.48**	$ 0.47
Diluted earnings per share:				
Net earnings	**$ 2,306**	$ 1,921	**$ 4,133**	$ 4,017
Weighted average common shares outstanding	**8,537**	8,457	**8,526**	8,493
Effect of stock options and warrants	**694**	534	**723**	543
Total weighted average common shares and common stock equivalents	**9,231**	8,991	**9,249**	9,036
Diluted earnings per share	**$ 0.25**	$ 0.21	**$ 0.45**	$ 0.44

Note 5. Stock-based Compensation

Flag currently accounts for stock-based compensation to employees and non-employee members of the Board under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. No stock-based employee compensation cost is reflected in net earnings, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

The following table illustrates the effect on net earnings and earnings per share if Flag had applied the fair value recognition provisions of SFAS No.123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation (in thousands, except per share amounts):

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	**2005**	2004
Net earnings as reported	**$ 2,306**	$ 1,921	**$ 4,133**	$ 4,017
Deduct: Total stock-based employee compensation expense determined	**(46)**	(28)	**(90)**	(55)

under fair value method for all awards, net of tax								
Pro forma net earnings	**$**	**2,260**	$	1,893	**$**	**4,043**	$	3,962
Basic earnings per share:								
As reported	**$**	**0.27**	$	0.23	**$**	**0.48**	$	0.47
Pro forma	**$**	**0.26**	$	0.22	**$**	**0.47**	$	0.47
Diluted earnings per share:								
As reported	**$**	**0.25**	$	0.21	**$**	**0.45**	$	0.44
Pro forma	**$**	**0.24**	$	0.21	**$**	**0.44**	$	0.44

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Note 5. Stock-based Compensation (continued)

During the six months ended June 30, 2005, Flag issued 81,500 options with a weighted average grant date fair value of $3.93 each. The fair value of each option was estimated on the date of grant using the Black-Scholes options-pricing model with the following assumptions: dividend yield ranged from 1.72% to 1.80%, volatility ranged from .2185 to .2225, risk free interest rate ranged from 4.24% to 4.36%, and an expected life of seven years.

Note 6. Loans

Flag engages in a full complement of lending activities, including permanent residential mortgage loans, permanent residential construction loans, commercial mortgage loans, commercial business loans, financial loans and consumer installment loans. Flag generally concentrates lending efforts on real estate related loans. As of June 30, 2005, Flag's loan portfolio consisted of 56.7% real estate mortgage loans, including 1-4 family residential loans, multi-family loans and commercial real estate loans, 28.9% real estate construction loans, 11.8% commercial and financial loans, and 2.6% consumer installment loans. While risk of loss is primarily tied to the credit quality of the various borrowers, risk of loss may also increase due to factors beyond Flag's control, such as local, regional and/or national economic downturns. General conditions in the real estate market may also impact the relative risk in the real estate portfolio. Of the target areas of lending activities, commercial and financial loans are generally considered to have a greater risk of loss than real estate loans or consumer installment loans.

Loans are reported at outstanding unpaid balances and unamortized premiums or discounts on purchased loans. Balances within the major loans receivable categories are represented in the following table (in thousands):

	June 30, 2005	**% of Total Loans**	December 31, 2004	% of Total Loans	June 30, 2004	% of Total Loans
Commercial/financial/agricultural	**$ 76,143**	**11.8%**	$ 57,231	9.5%	$ 61,429	11.6%
Real estate - construction	**187,271**	**28.9%**	176,111	29.1%	130,609	24.6%
Real estate - mortgage	**367,284**	**56.7%**	355,575	58.8%	323,902	61.1%
Consumer	**17,153**	**2.6%**	15,644	2.6%	14,183	2.7%
Lease financings	**11**	-	142	-	215	-
Total loans	**647,862**	**100.0%**	604,703	100.0%	530,338	100.0%
Less: Allowance for loan losses	**8,915**		8,602		7,489	
Total net loans	**$638,947**		$596,101		$522,849	

Note 7. Stock Repurchase Program

In March 2004, Flag's Board of Directors authorized a stock repurchase program covering an amount equal to 10% of the outstanding shares of Flag's common stock. As of June 30, 2005, the Company has repurchased approximately 304,000 shares of the approximately 853,000 shares authorized to be purchased, at an average price of $12.91.

Note 8. Subsequent Event

On July 18, 2005, the Company closed a private offering of 10,000 floating rate Preferred Securities offered and sold by Flag Financial Corporation Statutory Trust II (”Trust II”) having a liquidation amount of $1,000 each. The proceeds from such issuances, together with the proceeds of the related issuance of common securities of Trust II purchased by the Company in the amount of $310,000, were invested in floating rate Junior Subordinated Debentures (the “2005 Debentures”) of the Company totaling $10.3 million. The 2005 Debentures are due September 30, 2035 and may be redeemed after five years, and sooner in certain specific events, including in the event that certain circumstances render them ineligible for treatment as Tier 1 capital, subject to prior approval by the Federal Reserve Board, if then required. Such debentures presently qualify as Tier 1 capital for regulatory reporting. The sole assets of Trust II are the 2005 Debentures. The 2005 Debentures are unsecured and rank junior to all senior debt of the Company and on par with the debentures issued in connection with the Company’s other trust preferred securities. The Company owns all of the common securities of Trust II. The floating rate securities will reset quarterly at the three-month LIBOR rate plus 1.50%. Flag intends to use the capital for the merger with First Capital and for other general operating purposes. It is likely that Flag will issue additional trust preferred securities prior to the close of the First Capital transaction.

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Overview

The Company's net income for the quarter ended June 30, 2005, was $2.3 million, or $0.25 per diluted share, compared to net income of $1.9 million, or $0.21 per diluted share, for the June 30, 2004 quarter. Net income for the six months ended June 30, 2005, was $4.1 million, or $0.45 per diluted share, compared to $4.0 million, or $0.44 per diluted share for the six months ended June 30, 2004. Net interest income grew 25.7% and 23.0% to $9.2 million and $17.8 million for the quarter and six months ended June 30, 2005, respectively. Net interest income for the quarter and six months ended June 30, 2004 was $7.4 million and $14.5 million, respectively. The improvement in net interest income resulted from an increase in average loans outstanding as well as an increase in the yield on loans of 107 basis points and 102 basis points to 7.98% and 7.80% for the quarter and six months ended June 30, 2005, respectively. This compares to 6.91% and 6.78% for the same periods last year.

During the six months ended June 30, 2005, Flag has increased total assets by $34.2 million to $862.5 million from $828.3 million at December 31, 2004. Gross loans outstanding and total deposits have increased $43.2 million and $34.0 million, respectively, from December 31, 2004. Gross loans outstanding and total deposits in the metro Atlanta region grew $30.9 million and $51.4 million during the same time period.

While loans continued to grow, nonperforming assets continued to decline. Nonperforming assets were 0.57% of total assets at June 30, 2005, compared to 0.64% and 0.78% at December 31, 2004 and June 30, 2004, respectively. Net recoveries were 0.03% and 0.05% for the quarters ended June 30, 2005 and 2004, respectively. Net charge-offs for the six months ended June 30, 2005 and 2004, were 0.02% and 0.12%, respectively. The combination of net recoveries and improving overall credit quality allowed Flag to maintain the adequacy of the allowance for loan losses with no provision for loan losses in the quarter ended June 30, 2005. The allowance for loan losses at June 30, 2005, was 1.38% of total loans outstanding compared to 1.42% at December 31, 2004 and 1.41% at June 30, 2004. The ratio of the allowance for loan losses to nonperforming loans was 2.53 times, 2.00 times and 2.15 times at June 30, 2005, December 31, 2004 and June 30, 2004, respectively.

Mergers and Acquisitions

On May 26, 2005, Flag and First Capital Bancshares, Inc. ("First Capital") entered into a definitive agreement for Flag to acquire First Capital. First Capital, a bank holding company, is headquartered in Norcross, Georgia and is the parent company of First Capital Bank, which operates five banking offices in the north metro Atlanta market. The acquisition of First Capital will significantly accelerate Flag's growth strategy, more than doubling its presence in the metro Atlanta market. As of June 30, 2005, First Capital has approximately $675 million in assets. The consideration will be a combination of cash and stock with the transaction valued at approximately $122.7 million. The agreement has been approved by both boards of directors and is subject to regulatory and shareholders approvals. The merger is expected to close in the fourth quarter of 2005.

Prior to the close of the First Capital merger, the Company anticipates it will issue an additional $15.0 million in trust preferred securities to finance the transaction. The Company is also exploring different alternatives to raise additional capital of approximately $5.0 million, including a common stock issuance, exercise of warrants or increasing the amount of trust preferred securities issued.

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Forward-Looking Statements

The following discussion and comments contain "forward-looking statements" relating to, without limitation, future economic performance, plans and objectives of management for future operations, and projections of revenues and other financial items that are based on the beliefs of our management, as well as assumptions made by and information currently available to our management. The words "expect", "estimate", "anticipate", and "believe", as well as similar expressions, are intended to identify forward-looking statements. Our actual results may differ materially from the results discussed in the forward-looking statements, and our operating performance each quarter is subject to various risks and uncertainties. Factors that could cause actual results to differ from those discussed in the forward-looking statements include, but are not limited to, (i) the strength of the U.S. economy as well as the strength of the local economies in which operations are conducted; (ii) the effects of changing interest rates, which could lower margins; (iii) unanticipated inflation, interest rate, market and monetary fluctuations; (iv) unanticipated regulatory proceedings or legal actions, or changes in accounting policies and practices as adopted by the Financial Accounting Standards Board; (v) issues involved in the integration of acquisitions, including but not limited to our pending First Capital acquisition; and (vi) the timely development of products and services that position Flag to succeed in an increasingly competitive industry. If we are unsuccessful in managing the risks relating to these factors, together with other risks incident to the operation of our business, our financial condition, results of operations and cash flows could be adversely affected. Forward-looking statements speak only as of the date on which they are made. We undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made to reflect the occurrence of unanticipated events.

Critical Accounting Policies

The accounting principles we follow and our methods of applying these principles conform with accounting principles generally accepted in the United States and with general practices within the banking industry. In connection with the application of those principles, we have made judgments, estimates and assumptions which, in the case of estimating our allowance for loan losses (ALL), have been critical to the determination of our financial position and results of operations. Management assesses the adequacy of the ALL regularly during the year, and formally prior to the end of each calendar quarter. This assessment includes procedures to estimate the allowance and test the adequacy and appropriateness of the resulting balance.

This estimation process can affect our estimated loan loss expense for a given period. Generally, the allowance for loan losses increases as the outstanding balance of loans or the level of classified or impaired loans increases. Loans or portions of loans that are deemed uncollectible are charged against and reduce the allowance. The allowance is replenished by means of a provision for loan losses that is charged as an expense. As a result, our estimate of the allowance for loan losses affects our earnings directly.

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The ALL consists of two portions (1) allocated amounts representing the potential exposures on specifically identified credits and other exposures readily predictable by historical or comparative experience; and (2) an unallocated amount representative of inherent loss which is not readily identifiable. Even though the ALL is composed of two components, the entire ALL is available to absorb any credit losses. Allocated amounts are used on loans where management has determined that there is an increased probability or severity of loss than on the loan portfolio as a whole. We base the allocation for these unique loans primarily on risk rating grades assigned to each of these loans as a result of our loan management and review processes. We then assign each risk-rating grade a loss ratio, which is determined based on the experience of management, discussions with banking regulators and our independent loan review process. We estimate losses on impaired loans based on estimated cash flows discounted at the loan's original effective interest rate or based on the underlying collateral value. To the extent that management does not believe that a certain loan's risk is appropriately represented by the risk rating grades, a specific review of the credit is performed which would result in a specific allocation for that particular loan.

Unallocated amounts are particularly subjective and do not lend themselves to exact mathematical calculation. The unallocated amount represents estimated inherent credit losses which may exist, but have not yet been identified, as of the balance sheet date. In estimating the unallocated amount, we consider such matters as changes in the local or national economy, the depth or experience in the lending staff, any concentrations of credit in any particular industry group, and new banking laws or regulations. After we assess applicable factors, we evaluate the aggregate unallocated amount based on our management's experience. We then test the resulting ALL balance by comparing the balance in the ALL to historical trends and peer information. Our management then evaluates the result of the procedures performed, including the result of our testing, and concludes on the appropriateness of the balance of the ALL in its entirety.

The audit committee of our board of directors reviews the assessment prior to the filing of quarterly and annual financial information. In assessing the adequacy of the ALL, we also rely on an ongoing independent loan review process. We undertake this process both to ascertain whether there are loans in the portfolio whose credit quality has weakened over time and to assist in our overall evaluation of the risk characteristics of the entire loan portfolio. Our loan review process includes the judgment of management, input from our independent loan reviewer, and reviews that may have been conducted by bank regulatory agencies as part of their usual examination process.

See "Provision and Allowance for Loan Losses" for additional information.

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Summary Financial Data

The following table presents summary financial data for the previous five quarters (in thousands, except per share data).

	2005		2004		
(unaudited)	**Second Quarter**	First Quarter	Fourth Quarter	Third Quarter	Second Quarter
INCOME SUMMARY					
Interest income	**$ 14,064**	$ 12,787	$ 12,063	$ 10,813	$ 10,071
Interest expense	**4,817**	4,208	3,639	3,165	2,712
Net interest income	**9,247**	8,579	8,424	7,648	7,359
Provision for loan losses	**-**	375	375	375	375
Noninterest income	**2,592**	2,602	1,931	2,254	2,591
Noninterest expense	**8,422**	8,117	7,490	7,297	6,734
Earnings before taxes	**3,417**	2,689	2,490	2,230	2,841
Income taxes	**1,111**	862	798	571	920
Net earnings	**$ 2,306**	$ 1,827	$ 1,692	$ 1,659	$ 1,921
PERFORMANCE RATIOS					
Earnings per common share:					
Basic	**$ 0.27**	$ 0.21	$ 0.20	$ 0.20	$ 0.23
Diluted	**0.25**	0.20	0.19	0.19	0.21
Cash dividends declared	**0.06**	0.06	0.06	0.06	0.06
Return on average equity	**12.96%**	10.49%	10.25%	10.21%	11.59%
Return on average assets	**1.09%**	0.88%	0.86%	0.87%	1.07%
Net interest margin	**4.74%**	4.63%	4.62%	4.33%	4.52%
Yield on interest-earning assets	**7.19%**	6.84%	6.59%	6.11%	6.17%
Cost of interest-bearing liabilities	**2.71%**	2.44%	2.16%	1.94%	1.85%
Efficiency ratio	**70.99%**	71.83%	72.66%	74.00%	67.39%
Net overhead ratio	**2.76%**	2.66%	2.83%	2.64%	2.32%
Dividend payout ratio	**22.16%**	27.97%	30.14%	29.90%	26.63%
ASSET QUALITY					
Allowance for loan losses	**$ 8,915**	$ 8,862	$ 8,602	$ 8,328	$ 7,489
Nonperforming assets	**4,925**	6,740	5,310	5,907	5,853
Allowance for loan losses to loans	**1.38%**	1.44%	1.42%	1.41%	1.41%
Nonperforming assets to total assets	**0.57%**	0.80%	0.64%	0.74%	0.78%
Net (recoveries) charge-offs to average loans	**(0.03)%**	0.08%	0.07%	(0.04)%	(0.05)%
AVERAGE BALANCES					
Gross loans outstanding	**$ 619,511**	$ 603,412	$ 590,355	$ 566,691	$ 503,045
Mortgage loans held-for-sale	**7,153**	6,780	6,156	6,240	4,362

Interest-earning assets	**789,448**	772,409	733,709	710,765	663,258
Total assets	**845,847**	830,013	786,976	762,679	715,212
Deposits	**725,350**	707,934	670,725	629,221	572,871
Stockholders' equity	**71,183**	69,657	66,016	65,003	66,311
Common shares outstanding:					
Basic	**8,537**	8,515	8,337	8,263	8,457
Diluted	**9,231**	9,268	8,993	8,856	8,991
AT PERIOD END					
Gross loans outstanding	**$ 647,862**	$ 615,115	$ 604,703	$ 590,374	$ 530,338
Mortgage loans held-for-sale	**9,106**	7,271	10,688	6,666	5,964
Interest-earning assets	**805,442**	780,756	772,387	741,162	693,613
Total assets	**862,509**	840,415	828,337	793,038	749,371
Deposits	**740,803**	713,360	706,847	663,317	610,636
Stockholders' equity	**72,389**	70,297	69,202	65,038	64,392
Common shares outstanding	**8,546**	8,528	8,503	8,260	8,333

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Overview of Financial Condition

Total assets were $862.5 million at June 30, 2005, an increase of $34.2 million or 4.1% from $828.3 million at December 31, 2004. Interest-earning assets (consisting of loans, investment securities and short-term investments) totaled $805.4 million or 93.4% of total assets at June 30, 2005, compared to $772.4 million or 93.2% of total assets at December 31, 2004. During the same period, stockholders' equity increased $3.2 million or 4.6% to $72.4 million at June 30, 2005.

Loans
Gross loans outstanding (excluding mortgage loans held-for-sale) at June 30, 2005, totaled $647.9 million, an increase of $43.2 million or 7.1% from to $604.7 million at December 31, 2004. The increase is primarily attributable to the Company's continued growth in the metro Atlanta area. Loans in the metro Atlanta region grew to $410.3 million at June 30, 2005, compared to $379.4 million at December 31, 2004. As of June 30, 2005, loans in metro Atlanta represented 63.3% of gross loans outstanding. Mortgage loans held-for-sale totaled $9.1 million compared to $10.7 million at December 31, 2004. Flag concentrates its lending activities in several areas that management believes provides adequate diversification with acceptable yield and risk levels. These areas include, but are not limited to construction, commercial real estate, agricultural and correspondent lending (lending services to other community banks). For more information see Note 6 to the Notes to Consolidated Financial Statements and Management's Discussion and Analysis of Financial Condition and Results of Operations - Provision and Allowance for Loan Losses.

Investment Securities

Investment securities at June 30, 2005, totaled $123.1 million, a decrease of $1.4 million or 1.1% from $124.6 million at December 31, 2004. Investment securities comprised 15.3% and 16.1% of interest-earning assets at June 30, 2005 and December 31, 2004, respectively.

Federal Funds Sold and Other Interest-bearing Deposits

Short-term investments (federal funds sold and other interest-bearing deposits) totaled $20.4 million at June 30, 2005, a decrease of $6.5 million or 24.2% from $27.0 million at December 31, 2004. Short-term investments amounted to 2.5% of interest-earning assets at June 30, 2005 and 3.5% of interest-earning assets at December 31, 2004.

Premises and Equipment

Premises and equipment at June 30, 2005, totaled $13.6 million compared to $14.5 million at December 31, 2004. In the first quarter of 2005, Flag sold one of its banking centers with a net book value of $828,000 and recognized a pre-tax gain of $36,000. Flag maintains a branch location in the center under a lease agreement with the buyer.

Deposits and Other Funding

Total deposits at June 30, 2005, were $740.8 million, an increase of $34.0 million or 4.8% from $706.8 million at December 31, 2004. Core deposits offer the Bank a lower cost source of funds. Core deposits (noninterest-bearing demand deposits, interest-bearing demand deposits, and savings) were $421.8 million at June 30, 2005, compared to $417.7 million at December 31, 2004. Core deposits comprise 56.9% of the total deposit base at June 30, 2005 versus 59.1% at December 31, 2004. Total time deposits amounted to $319.0 million at June 30, 2005, compared to $289.2

million at December 31, 2004. Customer deposits represented 94.6% of total funding at June 30, 2005 and 93.9% at December 31, 2004. Total deposits in the Company's metro Atlanta region increased $51.4 million or 14.1% to $415.1 million at June 30, 2005, compared to $363.7 million at December 31, 2004. Core deposits in the same region increased $31.9 million or 16.7% to $223.2 million at June 30, 2005, from $191.3 million at December 31, 2004. Other borrowings decreased $2.7 million or 62.8% to $1.6 million at June 30, 2005, from $4.3 million at June 30, 2004. The decrease is due to principal repayments on an outstanding line of credit.

Advances from the Federal Home Loan Bank

Advances from the Federal Home Loan Bank ("FHLB") remained unchanged at $25.0 million at June 30, 2005 and December 31, 2004. Borrowings from the FHLB decreased during the past 12 months as a result of Flag's successful implementation of its deposit sales program.

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Liquidity

Liquidity management involves Flag's ability to maintain adequate short-term assets to meet the cash flow expectations of depositors and other lending institutions, and to provide funds for the growth in interest-earning assets. Liquidity is managed daily by understanding the cash flow expectations of depositors and other lending institutions and maintaining enough liquid assets to meet these expectations. As of June 30, 2005, Flag had $400.4 million of deposits due on demand, $21.4 million in savings deposits and $209.8 million of time deposits and other borrowings due within one year. Potential liquidity needs of these liabilities are met with liquid assets (assets that can be easily converted to cash). Liquid assets at June 30, 2005, totaled $114.3 million and included cash and due from banks, federal funds sold and other interest-bearing deposits, unpledged investment securities available-for-sale and mortgage loans held-for-sale. In addition to using liquid assets to meet potential liquidity needs, Flag maintains available lines of credit with other financial institutions. These include federal funds and other lines of credit totaling $48 million and a line of credit with the FHLB totaling $49 million. Flag also maintains a line of credit with the Federal Reserve Bank of Atlanta totaling $136 million. At June 30, 2005, $26.6 million of the available $233 million in total lines was advanced to Flag.

Off-Balance Sheet Arrangements

Flag is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments consist of commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Standby letters of credit are written conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. A commitment involves, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheets. Flag's exposure to credit loss in the event of non-performance by the other party to the instrument is represented by the contractual notional amount of the instrument.

Since certain commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Flag uses the same credit policies in making commitments to extend credit as they do for on-balance sheet instruments. Collateral held for commitments to extend credit varies but may include accounts receivable, inventory, property, plant, equipment, and income-producing commercial properties.

The following table summarizes Flag's off-balance sheet financial instruments whose contract amounts represent credit risk as of June 30, 2005 and December 31, 2004 (in thousands):

	2005	2004
Commitments to extend credit	**$ 203,715**	$ 142,036
Standby letters of credit	**$ 2,968**	$ 3,650

Market Risk Sensitivity

Market rate sensitivity is the tendency for changes in the interest rate environment to be reflected in Flag's net interest income and results of operations. Flag, through its asset and liability management program, seeks to balance maturities and rates on interest-earning assets and the corresponding funding such that interest rate fluctuations have a minimal impact on earnings and the value of Flag's equity.

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Flag Financial Corporation and Subsidiary
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Historically, the average term to maturity or repricing (rate changes) of assets (primarily loans and investment securities) has exceeded the average repricing period of liabilities (primarily deposits and borrowings). Flag's primary source of funding has been demand deposits (interest-bearing and noninterest-bearing) instead of time deposits and wholesale borrowings with longer maturities. This method of funding interest-earning assets has issues concerning interest rate risk, liquidity and profitability, all of which were contemplated and measured by the Company. Flag concluded that this strategy is the most profitable method of funding growth in interest-earning assets of the Company for the foreseeable future and has committed significant sales, marketing and training resources at being successful in this effort. Where interest rate risk is concerned, Flag considered factors such as account size, relationship strength and historical rate levels needed to remain competitive. Generally speaking, it is the opinion of management that these deposits are less sensitive to rate movements than the interest-earning assets they are funding. Flag uses an interest rate simulation model that uses management assumptions and theories regarding rate movements and the impact each movement will have on individual components of the balance sheet. As of June 30, 2005, Flag's simulation model shows that Flag's balance sheet is asset-sensitive, meaning a rising rate environment would have a positive impact on Flag's net interest income. The Company uses three standard scenarios — rates unchanged, rising rates, and declining rates — in analyzing interest rate sensitivity. At June 30, 2005, Flag's simulation model indicated that a 100 basis points increase or decrease over the next twelve months would increase net interest income approximately 5.68%, and decrease net interest income approximately 8.99% in the rising and declining rate scenarios, respectively, versus the projection under unchanged rates. Management expects that the Federal Reserve will continue to raise interest rates in 2005.

Management carefully measures and monitors market rate sensitivity and believes that its operating strategies offer protection against interest rate risk. As required by various regulatory authorities, Flag's Board of Directors established an interest rate risk policy, which sets specific limits on interest rate risk exposure. Adherence to this policy is reviewed by Flag's executive committee and presented at least annually to the Board of Directors.

Flag's management from time to time uses certain derivative instruments in an effort to add stability to the Company's net interest income and manage exposure to changing interest rates. Guidance for using these instruments is found in SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. Under the terms of this statement, all derivatives are classified as either fair value hedges (those designed to hedge the fair market value of asset or liabilities affected by changing interest rates) or cash flow hedges (those designed to mitigate exposure to variability in expected future cash flows due to changing interest rates).

At June 30, 2005, the Company had interest rate swaps and interest rate floors designated as cash flow hedges. No fair value hedges were outstanding. The following table summarizes the outstanding derivative instruments (dollars in thousands):

Interest Rate Swaps

Type	Transaction Date	Term Date	Notional	Receive Rate	Pay Rate	Current Spread	Fair Value
Receive Fixed, Pay LIBOR Swap	June 2004	Dec 2005	$ 5,000	2.68%	3.32%	(0.64)%	$ (26)
Receive Fixed, Pay LIBOR Swap	June 2004	June 2006	15,000	3.00%	3.32%	(0.32)%	(130)
Receive Fixed, Pay LIBOR Swap	June 2004	Dec 2006	5,000	3.27%	3.32		